Islamic Banking in India: Opportunities and Challenges

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The first Islamic bank in the world was founded in Egypt in 1963, and since than the phenomenon has grown slowly but steadily. In general, Islamic banks have performed as efficiently as conventional banks despite their self-imposed restrictions. Islamic finance, despite its name, is not a religious product. It is however a growing series of financial products developed to meet the requirements of a specific group of people. The qualitative method has been used. The qualitative approach is used to review the existing literature from all resources such as academic, scholarly journals, magazines, documents, workshops, and other related literature of Islamic finance industry. This paper will focus on basic principles of Islamic banking, opportunities and challenges of Islam Banking in India.

Key Words: Islamic banking, Interest free, Islamic finance, Economic growth.

I. INTRODUCTION
Islamic banking is banking or banking activity that is consistent with the principles of sharia (Islamic law) and its practical application through the development of Islamic economics. As such, a more correct term for Islamic banking is sharia compliant finance. The first model of Islamic banking system came into picture in 1963 in Egypt. Ahmad Al Najjar was the chief founder of this bank and the key features are profit sharing on the non interest based philosophy of the Islamic Shariah. These banks were actually more than financial institutions rather than commercial banks as they pay or charge interest on transactions. In 1974, the organization of Islamic Countries (OIC) had established the first Islamic bank called the Islamic Development Bank or IDB. The basic business model of this bank was to provide financial assistance and support on profit sharing. By the end of 1970, several Islamic banking systems have been established throughout the Muslim world, including the first private commercial bank in Dubai(1975), the Bahrain Islamic bank(1979) and the Faisal Islamic bank of Sudan (1977).

II. MAIN FEATURES
• It is a finance system based on the principle of not charging interest, prohibited under Islam. Now, it goes by a more formal moniker – participatory banking.
• Conventional finance includes elements (interest and risk) which are prohibited under Shari‘ah law. Developments in Islamic finance have arisen to allow Muslims to invest savings and raise finance in a way which does not compromise their religious or ethical beliefs. It is estimated that between 1.5 and 1.8 billion people (one quarter of the world’s population) are Muslim. Geographically, most Muslims live in Asia (over 60%) or the Middle East and North Africa (about 20%). Despite these figures, Islamic finance is still very much a niche market, with the vast majority of Muslims, who have access to finance, using conventional financial products.
• Conceptually, an Islamic bank has an equity-based capital structure, composed of shareholders’ equity and investment deposits based on profit and loss sharing. Just as supervisory issues such as capital adequacy ratios in conventional banking are regulated by the Basel Committee on Banking Supervision (BCBS), Islamic banks follow the standards prescribed by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). The most known factoid about Islamic banking is that it prohibits earning of interest, or riba. Muslims believe that profit should be based on effort; moneylenders expend little effort, their earnings accruing while they sit idle. Islamic banking also prohibits investment in activities considered haram, or sinful, according to sharia. Thus, projects involving alcohol, tobacco, pork products, weapons and defence, and pornography are all forbidden.
• The system also proscribes gambling and speculative activities. It should be mentioned that Islamic banks keep their doors open to all, including non-Muslims.

Islamic banking covers several types of financial contracts that vary in equity and profit-loss sharing. For the simplest accounts, Islamic banks perform a fiduciary role by primarily protecting the principle and sharing the surplus if any; for savvier depositors, the bank serves as an agency and provides administrative support. Modes of financing such as mudaraba (one partner provides the money and the other contributes expertise) and mushakara (investment, labour, expertise, risk is shared among all parties) may be seen as strictly profit-loss sharing, while murabaha (sale of goods in which profit margin is decided upon by both buyer and seller), ijara (leasing), and bai-us-salam (advance payment on future delivery of goods) are not. There also exist hybrid of these two types. To enlarge the field of
operations of Islamic banking, the requisite infrastructure has been slow to put in place. In 1995, the Dow Jones Islamic Markets Index (DJIMI), a listing of sharia-compliant portfolios, was launched. A special Sharia Supervisory Board oversaw the process, and the stocks are widely traded.

III. PRINCIPLES OF ISLAMIC BANKING
1. Sharing of profit and loss: the borrower and the lender share the profits as well as losses arising from the venture with the finances obtained from the lender. The basic view is that the general community should benefit from such activities.
2. Prohibition of investing in unlawful business: unlawful business involved inselling alcohol or pork; or business that produce media for instance, gossip columns or pornography, or gambling industry are prohibited in Islamic law.
3. Prohibition of Riba or interest: Islamic law prohibits receiving and giving interest, because interest deprives someone from the blessings of “Allah” as it leads to taking away of property actually belonging to someone.

IV. ISLAMIC BANKING IN INDIA
Based on Islamic banking principles Kerala sets the stage to start first Islamic nonbanking finance company (Al Barakah Financial Services Ltd) in India with the partnership of state government department (Kerala State Industrial Development Corp-KSIDC) after dismissal of petition filed by Subramanian Swami and RV Babu in High Court. Barakah would be a unique company with an authorized share capital of Rs.1,000 Crores and would perform on the principles of Islamic financial institutions. Al Barakah will not operate as a bank and extend loans but make direct investments in infrastructure projects not linked with pork, alcohol and other non Halal products, after which profits would be shared in the form of dividends and not an interest.

V. SCOPE OF ISLAMIC BANKING IN INDIANECONOMY
In India the scope of Islamic banking is very large because 140 million Muslims live in India which is around 15 per cent of the Islamic population. According to Standard & Poor's Ratings Services the potential market is $4 trillion worldwide; therefore this can be a tool for enhancing economic development in India. This will provide opportunities to the laborers and the working class belonging to the community. There are several foreign banks operating in India, like Citibank, Standard Chartered Bank, HBSC are operating interest free windows in several West Asian countries, USA and Europe. The growing awareness about the concept among Indian banks and it is generally felt that there is a huge potential market in India for Islamic banking. Several banks in the country have shown an inclination to undertake this form of interest-free banking. However, unless proper regulations are in place to oversee this form of banking, it will not be possible for scheduled commercial banks to follow the Islamic rules of banking even in a mail way. Islamic banking has been approved by RBI in India. This welcome development was expected after Dr. Raghuram Rajan took over as the governor of RBI replacing D. Subbarao whose position on Islamic Banking was not favorable. Dr Raghuram Rajan, a former Chief Economist of IMF and the Chief Economic Adviser to the Finance Ministry, was the head of the Committee of the Financial sector Reforms-CFSR of the Planning Commission which recommended Islamic Banking to be approved in India. So, on August 6, 2013 Dr. Manmohan Singh approved Dr. Raghuram's appointment as the governor of RBI, people like us got fresh hopes, and RBI finally gave a 'Go ahead' to it.

VI. OPPORTUNITIES
1. Efficiency: In the conventional banking system, the loans are given to those who are more credit-worthy. The banks get a pre-determined rate of interest, irrespective of what profit the business generated because of that loan. In contrast, in an interest-free banking, loans go to finance projects expected to be most productive and/or profitable and not to those who are most credit-worthy. Thus the problem with the conventional system is that credit-worthiness becomes more important than profitability of the project, which is inherently inefficient. In Islamic banks, since the returns to the banks would come out of the realized profits, the focus of the banks in deciding where to put its money will be on expected profits. This is more efficient because the savings are directed towards the high-yielding investments.
2. Stability: An interest-based financial inter-mediatory system is believed to be more unstable. This is primarily because of lack of synchronization between a firm's payment obligations to the banks and of expected profits or revenues. Payment of pre-determined interest obligation is fixed at specific intervals but the revenue generation amount and timings are uncertain. Inability to make interest payments may destabilize the system. Islamic banks overcome this drawback of the conventional banking by linking the payment obligation with the revenue generation and thus increase stability.
3. Justice: In a conventional banking system, businesses bear the risk as costs are incurred on expectations of profits which may or may not accrue. The owners of money are guaranteed their principal as well as interest. This is unfair as all risk is borne by one party and the other enjoys a risk-free return on their capital. Islamic banking, on the contrary, suggests that those who seek to earn a profit must also expose their principal to risk, for the only way to earn money on money is to do it through enterprise. An option in Islamic banking is that principal is guaranteed only in case when zero returns are stipulated. The interest based finance is unjust. In this system, one party bears the risk while the other enjoys a risk-free return.
4. Inclusions: Islamic Banking can be introduced for more The reasons why Islamic finance scores better than the conventional finance to enhance financial inclusion is because it is interest-free and risk-sharing of wealth and redistribution of wealth can be called two pillars of Islamic economics. Risk-sharing constitutes the core economic principles of Islam. Islam strictly prohibits all kinds of
interest-based contracts. The reason being that a party who wishes to be a beneficiary of profits should also be ready to share the loss if any, and thus profit-sharing and risk sharing is allowed and encouraged together. In the conventional system, risk is borne by only one party (borrower) and the other receives a fixed rate of return (interest) on the investments. Many financial instruments have evolved over time and are practiced in Islamic banking today, namely Mudarabah, Musharakah, Murabaha, Ijarah, Salaam, etc. However, in the context of financial inclusion Islamic Micro-finance and Micro-insurance or Micro-Takaful are more significant.

The Islamic law ensures economic justice along with economic growth through rules regarding resource allocation, production, exchange and the distribution of resulting income and wealth.

5. Upliftment of Muslims: One of the most important reasons of introducing Islamic Banking should be to improving the conditions of the largest minority in India, Muslims. Muslims are the most disadvantaged community in financial sector according to the Sachar Committee report. Due to interest based deposit and credit from commercial banks, 80% of Muslims are financially excluded. According to an RBI’s report, muslims loose around Rs 63,700 crores annually because they have a credit deposit ratio of 47% against national average of 74%. With 31% muslims living under poverty line and 40% muslim workers as own account workers, this big deficit can be covered by Islamic banking.

6. Increase Investments: India is a developing country and needs huge investments. Investment framework is favorable in India. India’s legal framework, which is the best in the region and it protects foreign investors. Also, the economies of neighboring Islamic countries have limited opportunities. India has abundant managerial and technical skill too. If India introduces Shariah-compliant banking, it can bring in more Arab petrodollars into the country. The western countries have also adopted Islamic banking to attract petrodollars. Introducing Islamic banking will not only please 175 million muslims living in India but will also attract Non-resident Indian Muslims to invest in India. All this will make more money available for investments.

7. Agricultural Development : Islamic banking is based on the principle of both risk and profit sharing. The products in Islamic banking are such that borrower has to make payments only when he has received returns on the money he had borrowed. The rate and time of returns are not pre-determined in Islamic banking unlike in conventional banking. Islamic banking also has a product, Qard-e-hasan, where money is lent on zero returns and the borrower is obligated to pay just the principal when he has sufficient funds.

VII. CHALLENGES

In the last couple of decades a few Islamic financial institutions has emerged offering some selected products or services. However, none of them really prospered and a full-fledged Islamic bank still remains a dream for the Indian Muslims. There are few obstacles which come in the way of any Islamic financial institution to succeed.

1. Legal Hurdle: The banking law in India, the Banking Regulation Act 1949, necessitates all banks to operate on the principle of interest. Thus, this prohibits the establishment of an Islamic bank which basically is a bank without interest. Further, because of the regulations regarding Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR), banks have to keep a large portion of their deposits on interest earning government and public sector securities.

The non-banking financial institutions emerged that operated according to Shariah law but could not prosper much because of frequent amendments that took place and the various restrictions that were imposed on these NBFCs.

2. Unequal Treatment of Debt and Equity: Under the existing rules in India, interest is exempted from tax while dividends are taxed. In an Islamic financial institution, the capital is equity based as it is operating through profit and loss sharing. This therefore is a big disadvantage for Islamic financial companies as compared to other conventional financial firms.

3. Lack of Islamic Insurance: Islamic banking and financial firms develop a sense of insecurity and lack of confidence as there is no provision of deposit insurance and credit guarantee unlike conventional commercial banks and cooperative societies which have these facilities. Besides non-availability of Islamic insurance schemes, lack of interest free instruments, undeveloped Islamic primary market and non-existence of secondary marker for Islamic product are some other serious problems of Islamic financial firms.

4. Lack of Transparency: To promote and restore confidence of investors there should be transparency in profit distribution, financial documentation and compliance to both the government’s as well as Shariah rules. However, Islamic financial firms have not been able to meet these expectations. There is always a fear of mis-reporting of profits by borrowers. Besides, there is no heavy penalty for defaulters, and hence again a fear of its misuse.

5. Lack of Credit Rating Agencies for Islamic Financial Institutions: There are many credit rating agencies for the conventional financial firms but there are no such rating agencies to rate the Islamic financial firms. This leads to lack of confidence among the investors.

6. Lack of Qualified Shariah Experts : The lack of qualified Shariah experts only increases the woes of the investors to check if any firm is actually operating as per Shariah law.

VIII. SWOT ANALYSIS OF ISLAMIC-BANKING IN INDIA

SWOT analysis is an important to identify the strengths and opportunities available and to devise strategy to utilize them fully, while identification of weaknesses and threats help identify the risk and take precautionary steps. SWOT analysis of Islamic Banking is undertaken to understand its potential in India.
Strengths: Islamic banking has become very popular across the world in a short span of time and with India's robust banking structure has great potential to do well in India as well. Islamic banking is more stable than conventional banks as its financing is asset based and not debt based like conventional banking and hence does not lead to high rates of inflation. The foundation of Islamic banking is Islamic economics which lays great emphasis on inclusive growth and poverty alleviation. Islamic banks are more immune to instability as evidenced during the global financial crisis.

Weaknesses: The biggest weakness in the current scenario is the lack of provision of interest-free banking as per banking regulations in India. Most of the people are ignorant about Islamic-Banking as they believe that it is a banking system only for Muslims. Islamic banking desires greater level of business ethics and in India that is yet to evolve. Lack of close bank-clientele relationship environment which is essential for Islamic banking. Islamic banking demands greater monitoring of the operations. Lack of Shariah experts

Opportunities: Huge market size specially large muslim population is big opportunity for Islamic Banks. Growing Indian economy has huge potential to attract investments from cash surplus Muslim countries. Large number of Muslims avoid participating in the conventional banking system and as a result large credit is not utilized. The financially excluded Muslims can be beneficiaries of Islamic banking. Islamic Microfinance has huge potential as it evident from its success abroad.

Threats: The biggest threat is that introduction of Islamic banking could be seen as threat to secularism and may result in political turmoil. Having two parallel banking stream may give rise to communalism. The above analysis weighs in favour of Islamic banking and the weaknesses and threats are relatively small and manageable as compared to the huge potential and opportunities that Islamic-Banking offers.

IX. CONCLUSION

India has the second largest Muslim population in the world but a large portion of this has not been able to access the banking services because as per Islamic principles, giving or receiving interest is prohibited though money can be lent on profit sharing or fee based model. There is nothing inherently problematic about this system; investors are free to choose between conventional and Islamic finance, and the pitfalls of conventional investments such as investor knowledge, information asymmetry, and agency problems also apply to Islamic banking. Like conventional banking, Islamic banking also will require periodic audits and stringent rules on transparency. The findings of research will be of interest to Islamic financial practitioners, policy makers and academicians, who are interested in Islamic finance industry. In today’s world Islamic banking is gaining more importance in different parts of the world. If Islamic banking is opened in India it would benefit the Indians as those money which are still lying in the banks if invested in the Islamic bank would improve the economic conditions of the Muslims.

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